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14010—37

# In the Supreme Court of the United States

OCTOBER TERM, 1937

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GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

BANKLINE OIL COMPANY, A CORPORATION

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**PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT**

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The Solicitor General, on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Ninth Circuit entered in the above cause on June 7, 1937, reversing the decision of the United States Board of Tax Appeals.

## OPINIONS BELOW

The opinion of the Circuit Court of Appeals (R. 145) is not yet officially reported. The opinion of the Board of Tax Appeals (R. 42–56) is reported at 33 B. T. A. 910.

## JURISDICTION

The judgment of the Circuit Court of Appeals was entered June 7, 1937 (R. 154). The juris-

diction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

## QUESTION PRESENTED

The taxpayer, a casinghead gasoline manufacturer engaged in the processing of wet gas into gasoline and dry gas, obtains its supply of wet gas by contract with oil producers. Is the taxpayer entitled to an allowance for depletion of gas in place because the contract price which it paid for wet gas is below the market price at the time of delivery of the wet gas to the taxpayer by the producers?

## STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved will be found in the Appendix, *infra,* pp. 10–14.

## STATEMENT

The facts as found by the Board of Tax Appeals (R. 43–45) may be summarized as follows:

The taxpayer, a corporation, maintained and operated during each of the taxable years 1927, 1928, and 1930, a casinghead gasoline plant situated in the Signal Hill Oil Field, of Los Angeles, California. In this plant, taxpayer processed raw natural gas, called wet gas, which is not a salable commodity, to secure the two salable commodities gasoline and dry gas. Taxpayer's supply of wet gas was obtained from oil producers under con-

tracts, entered into prior to the taxable years, providing that the taxpayer should install and maintain necessary pipe lines and connections from casingheads or traps at the mouth of the well to its plant, through which to carry the wet gas which the producer delivered. The taxpayer agreed to pay the producer 33⅓ percent of the total gross proceeds derived from the sale of gasoline, or at the producer's option to deliver 33⅓ percent of the extracted gasoline.

Under the contracts (R. 76–115) the taxpayer took no part in the production of the wet gas, conducted no drilling operations upon any of the producing premises, did not pump oil or gas from the wells, and had no interest as lessor or lessee, or as sublessor or sublessee, in any of the producing wells.

The Commissioner determined deficiencies against the taxpayer upon other issues than the depletion issue here involved. By amended petitions (R. 19–25, 35–40) the taxpayer urged that in computing its taxable net income it was entitled to deduct from gross income percentage depletion, in the amount of 27½ percent of gross income, provided such amount did not exceed 50 percent of the net income which it realized under its casinghead gas contracts. The record does not show the net income (computed without allowance for depletion) which petitioner realized under its wet gas treatment contracts.

The Board of Tax Appeals held (R. 47–56) that the interest of the taxpayer under its casinghead gasoline contracts was not in the nature of a profit a prendre; that the contracts gave the taxpayer no interest in the gas in place but only a right to delivery of wet gas after its production and reduction to ownership by others; and that in consequence the taxpayer had wholly failed to establish depletable interest under the statute. The Board held further, however, that if, as a matter of law, a casinghead gasoline plant operator may in some instances have a depletable interest under gas treatment contracts, the taxpayer had failed to show that the value of wet gas at the mouth of the well purchased under its casinghead gasoline contracts was in excess of the amount paid therefor, and in consequence had not shown any proper basis for deductions or the amount of the deductions to be taken in the taxable years.

The Circuit Court of Appeals held that the taxpayer as a casinghead gasoline plant operator had *under its contracts* an economic interest in the wet gas in place which would entitle it to a depletion allowance *provided* the fair market value of wet gas at the casinghead or gas trap exceeded the contract price which taxpayer paid for such wet gas. So holding, and because the record did not show the taxpayer's net income (computed without allowance for depletion) from "the property", the Circuit Court of Appeals reversed the decision be-

low and remanded the case to the Board of Tax Appeals with instructions to allow additional evidence and to fix the depletion allowance in accordance therewith. The Board had held that the wet gas as it flows from the earth is not a salable commodity (R. 44), and the concurring opinion in the Circuit Court of Appeals expressed the view that such a commodity could not have a market value.

### SPECIFICATION OF ERRORS TO BE URGED

The court below erred:

1. In holding that the nature of the taxpayer's contracts for a supply of wet gas was such that the taxpayer was entitled to an allowance for depletion, provided it paid less for wet gas under its gas treatment contracts than the market value of such wet gas as established by the current contract price generally being paid in that field under similar contracts entered into during the taxable years.

2. In failing to hold that the taxpayer had no interest in the wet gas in place in the earth which could be the subject of a deduction for depletion.

3. In reversing the decision of the Board of Tax Appeals.

### REASONS FOR GRANTING THE WRIT

1. In the present case, the Circuit Court of Appeals for the Ninth Circuit has established the rule for its jurisdiction that casinghead gasoline manufacturers are entitled to an allowance for depletion

if the price which they pay for wet gas to the producer thereof is less than the fair market value of the wet gas at the gas trap or casinghead at the time the wet gas is delivered. In so holding, the Circuit Court of Appeals stated that the right to depletion depends upon an economic interest in the oil or gas in place, and purported to rely upon *Palmer* v. *Bender*, 287 U. S. 551.[1] But the court's conception of an economic interest in the oil or gas in place as presented in this case, and further illustrated by its decision in *Commissioner* v.

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[1] In addition the court below relied upon its own decision in *Signal Gasoline Corp.* v. *Commissioner*, 66 F. (2d) 886, which was also based upon *Palmer* v. *Bender*. Whatever may be the validity of the *Signal Gasoline Corp.* decision, it is clearly distinguishable. There, unlike the present case, the casinghead gas manufacturer had paid a substantial consideration for its gas contracts; had taken direct means to induce a larger flow of oil and gas; had extracted wet gas from the wells by various means; and had assisted in drilling wells by furnishing equipment. Concerning the contracts in that case, the court said (p. 889) that they imposed upon the Signal Gasoline Corporation "the obligation to * * * exert forces which would bring the oil and gas up out of the ground." As a result, the court reached the conclusion in the *Signal Gas* case (p. 889), which it could not possibly reach here, that the oil producer and the casinghead gas processor "were both engaged in continuous steps to win oil and casinghead gas from their position in the earth."

The second decision in the *Signal Gas* case, 77 F. (2d) 728, certiorari denied, 296 U. S. 657, involved merely the method of calculation of the depletion allowance.

*O'Donnell,*[2] is in probable conflict with *Palmer* v. *Bender, supra,* and with *Thomas* v. *Perkins,* No. 824, October Term, 1936, decided June 1, 1937. The holding below is also in conflict with the decision of the late Judge McDermott, of the Tenth Circuit, sitting as a district judge, in *Hurley* v. *United States,* 10 F. Supp. 365 (N. D. Okla.).

The *Palmer* and *Perkins* cases require that a taxpayer claiming depletion must own some interest in the mineral in place. Here the taxpayer was operating a plant to extract gasoline from gas, and was not engaged in operating a gas or oil well. Under its contracts, taxpayer's earliest possible interest in wet gas was upon delivery by the producer to the trap or casinghead. Each of the contracts specifically provided that the oil producer was the owner of the wet gas produced from the oil properties described (R. 76–77), or was drawn in terms of purchase of the wet gas by the taxpayer and sale by the oil producer (R. 90, 99, 107, 108). Taxpayer was under no obligation to engage in the production of wet gas from the ground, nor could it require such production. Taxpayer's only interest in the wet gas reserves was the same as that of an oil refinery—if its supply of wet gas ran out, it would have to seek other sources for that raw material for its plant. Nor can it in any sense be said in this case that taxpayer secured "by any form of legal relationship, income derived from the

[2] Decided June 14, 1937. The case is not yet reported but may be found in 1937 C. C. H. par. 9362. The Government will file a petition for certiorari in the O'Donnell case.

extraction of the oil, to which he must look for a return of his capital." See *Palmer* v. *Bender*, *supra*, at p. 557. Taxpayer's capital was invested in its processing plant, and its income was not derived from extraction of the oil or gas from the ground, but from the processing of wet gas previously extracted from the ground by independent producers. Moreover, since it is the mineral deposit which is depleted by production, the taxpayer whose interest is confined to the extracted mineral is not within the class of "mines, oil and gas wells, other natural deposits, and timber" to which Section 23 (l) of the statute, *infra*, p. 11, alone applies.

2. An authoritative decision by this Court on the question presented is of great importance to the orderly allowance and proper apportionment of depletion. The question can arise in any jurisdiction where similar casinghead gas production takes place, but appears to be most pressing in the Ninth Circuit. *Norwalk* v. *Commissioner*, now pending before the Ninth Circuit Court of Appeals (No. 8468), presents the same question, and several other cases which will eventually reach the Ninth Circuit Court of Appeals are in earlier stages of litigation.

Furthermore, if the present decision is allowed to stand, the Commissioner must allocate the allowance for depletion between the producer (including all those interested with the producer in and

under the lease; i. e., the lessor and holders of various interests under the lease) on the one hand, and the casinghead gasoline manufacturer on the other. Reduction of the depletion allowance allocable to producer interests will doubtless result in litigation by those interests and probable conflicts of decision. The Bureau of Internal Revenue advises that within the last three years the Commissioner has rejected claims for depletion allowances advanced by approximately 50 casinghead gasoline manufacturers. In addition there are at least 150 casinghead gasoline manufacturers who have not claimed depletion allowances for past years but may still do so. A decision by this Court in the present case will avoid a situation whereby doubtful allowances must be made by the Commissioner to one group and corresponding disallowances to another. Such a condition cannot fail to be productive of further litigation and to be unsatisfactory to the Government and taxpayer alike.

## CONCLUSION

Wherefore, it is respectfully submitted that this petition for a writ of certiorari should be granted.

STANLEY REED,
*Solicitor General.*

SEPTEMBER 1937.

## APPENDIX

Revenue Act of 1926, c. 27, 44 Stat. 9, 16, 41:

SEC. 204. (c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—

* * * * *

(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

SEC. 234. (a) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * *

(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed

by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee; * * *.

Revenue Act of 1928, c. 852, 45 Stat. 791, 799, 821:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(l) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction shall be equitably apportioned between the lessor and lessee. * * * (For percentage depletion in case of oil and gas wells, see section 114 (b) (3).)

(m) *Basis for depreciation and depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in section 113 for the purpose of determining the gain or loss upon the sale or other disposition of such property, as is provided in paragraphs (2) and (3) of this subsection.

(b) *Basis for Depletion.*—

* * * * *

(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

* * * * *

Treasury Regulation 69, promulgated under the Revenue Act of 1926:

ART. 201. *Depletion of mines, oil and gas wells; depreciation of improvements.*—Sections 214 (a) (9) and 234 (a) (8) provide that taxpayers shall be allowed as a deduction in computing net income in the case of natural deposits a reasonable allowance for depletion of mineral and for depreciation of improvements. See section 204 (c) and articles 1602 and 221 with reference to the basis for computing depreciation and depletion.

The essence of these provisions of the statute is that the owner of mineral deposits, whether freehold or leasehold, shall, within the limitations prescribed, secure through an aggregate of annual depletion and depreciation deductions the return of either the cost of his property, or the value of his property on the basic date plus, in either

case, subsequent allowable capital additions (see articles 222 and 223), but not including land values for purposes other than the extraction of minerals. (But see section 204 (c) (2) and article 221.)

Operating owners, lessors, and lessees, whether corporations or individuals, are entitled to deduct an allowance for depletion and depreciation, but a shareholder in a mining or oil or gas corporation is not allowed such deductions. (But see article 1546.)

* * * * *

ART. 1602. *Basis for allowance of depletion and depreciation.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence will be allowed in respect of any property is the same as is provided in section 204 (a) and (b) for the purpose of determining the gain or loss from the sale or other disposition of such property, except that:

* * * * *

(2) With respect to oil and gas wells, the allowance for depletion shall be 27½ per cent of the gross income from the property during the taxable year, but such allowance shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. In no case shall the deduction for depletion with respect to oil and gas wells be less than it would be if computed without reference to section 204 (c) (2) and this paragraph.

See articles 201–237 for the methods of computing allowances for depletion, and articles 161–170 with reference to the allowance for depreciation.

Treasury Regulations 74 promulgated under the Revenue Act of 1928: The applicable Articles of these Regulations are substantially similar to the corresponding Articles in Regulations 69, *supra*, and are not copied here (Cf. Articles 221, 611, Treasury Regulations 74).

U. S. GOVERNMENT PRINTING OFFICE: 1937

# PETITIONER'S BRIEF

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# In the Supreme Court of the United States

OCTOBER TERM, 1937

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No. 387

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

BANKLINE OIL COMPANY, A CORPORATION

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*ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT*

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## BRIEF FOR THE PETITIONER

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### OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 42–56) is reported in 33 B. T. A. 910. The opinion of the Circuit Court of Appeals is reported in 90 F. (2d) 899.

### JURISDICTION

The judgment of the Circuit Court of Appeals was entered June 7, 1937 (R. 154). Petition for certiorari was filed September 7, 1937, and was granted October 25, 1937. The jurisdiction of this

Court is conferred by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

## QUESTION PRESENTED

The taxpayer, a casinghead gasoline manufacturer engaged in the processing of wet gas into gasoline and dry gas, obtains its supply of wet gas by contract with oil producers. Is the taxpayer entitled to an allowance for depletion of gas in place because the contract price which it paid for wet gas is below the market price at the time of delivery of the wet gas to the taxpayer by the producer?

## STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved will be found in the Appendix, *infra*, pp. 20–23.

## STATEMENT

The facts as found by the Board of Tax Appeals (R. 43–45), pertinent to the above question, may be summarized as follows:

The taxpayer, a corporation, maintained and operated during each of the taxable years 1927, 1928, and 1930, a casing-head gasoline plant situated in the Signal Hill Oil Field, Los Angeles, California. In this plant, taxpayer processed raw natural gas, known as "wet gas," into gasoline and dry gas. (R. 43–44.)

Natural gas, commonly known as "wet gas" as it flows from the earth is not a saleable commodity.

It is only through processing—by separation of the gasoline therefrom—rendering it dry, that it may be sold for commercial uses. Conversely, it is only through the separation of dry gas from wet gas that the gasoline is saleable. The content of gasoline in wet gas varies from one-half gallon to six gallons per thousand cubic feet of gas produced, depending upon its richness. (R. 44.)

In and prior to the taxable years the petitioner entered into numerous contracts[1] with oil producers for the treatment of "wet gas" by the extraction of gasoline therefrom. The contracts provided, generally, that respondent should install and maintain the necessary pipe lines and connections from casingheads or traps at the mouth of the well to its plants, through which the producer agreed to deliver to the respondent's plant the natural gas produced at such well. (R. 44.) Respondent agreed to extract the gasoline and to pay the producer one-third of the total gross proceeds derived from the sale thereof, or at the option of the producer, one-third of the saleable gasoline so extracted. A slightly different type of such contract provided for the outright "purchase" from the producer of all natural gas produced, respondent paying one-third of the gross proceeds received by it from the sale of gasoline extracted from such gas. When dry gas was sold respondent

[1] Entirely distinct from the leases of state lands involved in No. 388 under taxpayer's cross petition for certiorari.

accounted to the producer for a proportion of the proceeds. (R. 45.)

Under the contracts (R. 76–115) taxpayer took no part in the production of the wet gas, conducted no drilling operations upon any of the producing premises, did not pump oil or gas from the wells, and had no interest as lessor or lessee, or as sublessor or sublessee in any of the producing wells.

The Commissioner determined deficiencies against the taxpayer upon other issues, and by amended petitions (R. 19–25, 35–40), the taxpayer urged that in computing its taxable net income it was entitled to deduct from its gross income, as percentage depletion, 27½ per cent of the difference between the price paid for the wet gas and its fair market value at the mouths of the wells.

The Board of Tax Appeals held that under the contracts the taxpayer acquired no depletable interest. It further held that the taxpayer had failed to show that the value of wet gas purchased was in excess of the amount paid therefor, and therefore upon its own theory it had not shown any proper basis for deduction.

The Circuit Court of Appeals held that the taxpayer had under its casinghead contracts acquired an economic interest in the wet gas in place which would entitle it to depletion, provided the fair market value of the wet gas at casinghead or gas trap exceeded the price which taxpayer paid for such wet gas. So holding, and because no finding had been made of the fair market value of the wet gas,

nor of taxpayer's *net* income, it remanded with instructions to allow additional evidence as to depletion, and to fix the allowance in accordance with the court's opinion.

### SPECIFICATION OF ERRORS TO BE URGED

The court below erred:

1. In holding that the nature of the taxpayer's contracts for a supply of wet gas was such that the taxpayer was entitled to an allowance for depletion, provided it paid less for wet gas under its gas treatment contracts than the market value of such wet gas as established by the current contract price generally being paid in that field under similar contracts entered into during the taxable years.

2. In failing to hold that the taxpayer had no interest in the wet gas in place in the earth which could be the subject of a deduction for depletion.

3. In reversing the decision of the Board of Tax Appeals.

### SUMMARY OF ARGUMENT

Depletion represents capital extracted from the property. Ownership of the oil or gas as produced, or of its proceeds, is the basis for recognition of a depletable economic interest in the oil or gas in place. The depletion allowance is a percentage of "gross income from the property," which, as here applied, means gross income from wet gas produced.

The respondent is a processor of wet gas not distinguishable from a refiner of crude oil. Under its contracts it acquired no economic interest in wet

gas in place. The contracts were agreements to purchase from, or treat for, the producers wet gas which the producers extracted from their deposits and which became the personal property of the producers when reduced by them to possession in their gas traps or casingheads. The respondent unquestionably did not own the wet gas as produced. The producers accordingly were the sole recipients of "gross income from the property," and solely entitled to depletion. The respondent at best has a mere economic advantage arising out of favorable contracts with the producers, which will cease whenever the contracts cease to be favorable. It is clearly improper to allow depletion for the wasting of an "investment" which is dependent for its existence upon shifting price trends.

ARGUMENT

The theory of Congress in permitting a deduction for depletion is that it will compensate the owner of a wasting asset for the exhaustion sustained in the production of taxable income. In other words, depletion represents capital extracted from the property. *United States* v. *Ludey*, 274 U. S. 295. Ownership of the mineral in place—a capital interest—is, therefore, a prerequisite of the right to a depletion allowance.

Section 23 (1) of the Revenue Act of 1928, which contains the general authorization of the deduction on account of depletion, provides:

> In the case of mines, oil and gas wells, other natural deposits, and timber, a reason-

> able allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case. * * *

The provision clearly assumes the prerequisite of ownership. The assumption becomes explicit and a test of ownership is furnished in Section 114 (b) (3), which sets forth the basis of percentage depletion:

> In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the *gross income from the property.*

The Government's basic contention in this and the three cases to be argued immediately after it[2] is that only recipients of "gross income from the property"—that is, only owners of gas and oil, *as produced*—have such an ownership of, or interest in, the mineral in place as to entitle them to depletion.

The decisions of this Court have uniformly confined the right to participate in the allowance for depletion to persons entitled to payments out of oil or the gross proceeds of oil, and have permitted the deduction only from the royalty payments themselves or from cash payments which could be regarded as advance royalties paid in anticipation of the extraction of oil. They uniformly recognize that the right thus to share in the oil as it comes

[2] No. 406 (*Helvering* v. *O'Donnell*); No. 446 (*Helvering* v. *Elbe Oil Land Development Co.*); No. 600 (*Helvering* v. *Mountain Producers Corp.*).

from the well is indispensable to ownership of a depletable interest in the oil in place.

The leading case is *Palmer* v. *Bender*, 287 U. S. 551. There the taxpayer in consideration of a purported assignment of oil leases received, in addition to a cash bonus, the right to a stated proportion of all the oil produced and saved. The Government contended that under local law the transaction constituted a sale rather than a sublease. The taxpayer urged the contrary. This Court held (p. 555) that the application of the statute was not to be "controlled or varied by any particular characterization by local law of the interests to which it is to be applied." The statute itself fixes the standard for its application. Concerning that standard, the Court said (p. 557):

> The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, *any interest in the oil in place*, and secures, by any form of legal relationship, income *derived from the the extraction of the oil*, to which he must look for a return of his capital. * * * [Italics supplied.]

Technical legal ownership of the mineral before extraction, the Court held, is not necessary to establish an interest in the oil in place.

> * * * the lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. It is enough if, by virtue of the

> leasing transaction, he has retained a *right to share in the oil produced.* If so he has an economic interest in the oil, in place, which is depleted by production. [Italics supplied.]

The decision in *Palmer* v. *Bender,* in the Government's view, establishes four propositions: (1) that an interest in oil or gas *in place* is a prerequisite to participation in the depletion allowance; (2) that the existence of such an interest is to be determined by uniform Federal law and not by the peculiarities of local law; (3) that technical legal ownership of the oil or gas *in place* is unnecessary; and (4) that the decisive test of the requisite interest, or ownership, is the right to share in the oil or gas *as produced.*

Later cases have emphasized these elements of the decision. In *Helvering* v. *Twin Bell Oil Syndicate,* 293 U. S. 312, 321, the Court stated that the phrase "gross income from the property" "points only to the gross income from oil and gas." The holding of the *Palmer* case was extended to the situation where the lessee, instead of turning over royalty oil in kind, sold all the oil and paid over the royalty in the form of cash. The decision plainly was predicated upon the same reasoning as in the *Palmer* case. More recently still, in *Thomas* v. *Perkins,* 301 U. S. 655, the Court, in discussing the *Palmer* case, said (p. 661):

> Thus in that case we held assignors' mere stipulation for royalty *out of oil* operated

> to save them an economic interest *in the oil* sufficient to entitle them to deduct from their income derived *from the oil* an allowance for depletion. If Palmer had retained no interest in the oil he would have been entitled to no deduction on account of depletion. *Ownership was essential.* [Italics supplied.]

The Court also pointed out that there is no difference, so far as ownership is concerned, between cost and percentage depletion.

The court below, citing its own decision in *Signal Gasoline Corp.* v. *Commissioner,* 77 F. (2d) 728, and relying upon the decision of this Court in *Palmer* v. *Bender, supra,* held that the respondent, processor of wet gas, was entitled to an allowance for depletion if the price which it paid for wet gas to the producer thereof was less than the fair market value of the wet gas at the gas trap* or casinghead at the time the wet gas was delivered. The court recognized that the right to depletion depends upon an economic interest in oil or gas in place, but its conception of such an interest, as a commentator has said, "would seem to read into the phrase * * * a content not intended by the *Palmer* decision and to give it some indefinite meaning totally divorced from any idea of return of capital assets." See 47 Yale Law Journal 278, 280.

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*A device to separate oil that is carried along with the gas (R. 136).

The theory of the lower court's decision in the instant case is best illustrated by a quotation from its opinion in *Signal Gasoline Corp.* v. *Commissioner, supra* (p. 730):[4]

> It is apparent that if the petitioner's contract was such that it was required to pay the full market value of the wet gas as it was produced by the wells it had no capital investment in the well or in the oil content of the land, and had no advantage over a manufacturer who bought his wet gas on the market other than the exclusive right to the product of the particular wells from which it derived the gas. * * * The person who paid the market price to the lessee or owner would suffer no damage of capital investment in the oil or gas in place under such

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[4] *Signal Gasoline Corp.* v. *Commissioner*, 66 F. (2d) 886, was also based upon *Palmer* v. *Bender*. Whatever may be the validity of the *Signal Gasoline Corp.* decision, it is clearly distinguishable. There, unlike the present case, the casinghead gas manufacturer had paid a substantial consideration for its gas contracts; had taken direct means to induce a larger flow of oil and gas; had extracted wet gas from the wells by various means; and had assisted in drilling wells by furnishing equipment. Concerning the contracts in that case, the court said (p. 889) that they imposed upon the Signal Gasoline Corporation "the obligation to * * * exert forces which would bring the oil and gas up out of the ground." As a result, the court reached the conclusion in the *Signal Gasoline Corp.* case (p. 889), which it could not possibly reach here, that the oil producer and the casinghead gas processor "were both engaged in continuous steps to win oil and casinghead gas from their position in the earth."

The second decision in the *Signal Gasoline Corp.* case, 77 F. (2d) 728, certiorari denied, 296 U. S. 657, involved merely the method of calculation of the depletion allowance.

> circumstances. If we assume, however, that the petitioner by reason of his favorable contract with the producer secures the wet gas when produced at a fraction of its market price at the time it is produced, say one-half for the purpose of illustration, it is clear that petitioner to that extent (50 per cent) would have his interest in the wet gas in place in the land reduced by one-half of the amount produced. * * *

This holding is clearly a misapplication of the principles announced by this Court. See pp. 7–10, *supra*.

*Ownership* of the oil or gas as produced, or of its proceeds, is the basis for recognition of a depletable economic interest in the oil or gas in place. Where such ownership does not exist, there is no basis for depletion. To repeat what this Court said in *Thomas* v. *Perkins, supra,* in discussing *Palmer* v. *Bender:*

> If Palmer had retained no interest in the oil he would have been entitled to no deduction on account of depletion. *Ownership was essential.*

It is only the owner of the gas or oil as produced, or of its proceeds, who may be said, within the meaning of the statute to receive "gross income from the property"—namely, from the gas or oil. *Helvering* v. *Twin Bell Oil Syndicate, supra.*

The respondent unquestionably, we submit, did not own the wet gas as produced. It did not engage in production of the gas, nor could it com-

pel its production. It was merely entitled by virtue of contract either to purchase the wet gas produced or to process it, retaining a share of the proceeds as compensation for its services. The respondent thus had no right in any particular unit of gas *as produced,* other than the right to have it delivered pursuant to contract. The gas to be purchased had to be paid for. The gas to be processed yielded what was in effect a commission. In this connection the Board said (R. 54):

> It is safe to say, we believe, that this petitioner had no enforceable rights whatsoever under its contracts prior to the time the wet gas was actually placed in its pipe line, i. e., after it had passed beyond the casingheads and gas traps supplied by the producer and into the pipe line, except the right, perhaps, to demand that the producer deliver whatever was produced through its pipe lines for treatment during the period of contractual relationship.

Each of the contracts specifically provided that the oil producer was the owner of the wet gas produced from the oil properties (R. 76–77), or was drawn in terms of purchase of the wet gas by the taxpayer and sale by the oil producer (R. 90, 99, 107, 108).*

In *Hurley* v. *United States,* 10 F. Supp. 365 (N. D. Okla.), it was contended that a casinghead gaso-

* The court below made no distinction between the gas treatment contract and the contract of sale; nor did respondent's witness Taggart (R. 127).

line manufacturer was entitled to depletion. The court said (pp. 367–368):

> In order to come within the quoted section the plaintiff's business must fall within the category of "mines, oil and gas wells." The plaintiff was operating a plant designed to extract gasoline from gas; it was not operating a mine, nor an oil or gas well. * * * it did not own a gas well; it had no interest in the lease, nor in the gas reserves, * * *. It seems to me that this situation is closely analogous to that of an oil refinery, which is constructed for the purpose of refining crude oil. It buys the crude oil from others * * *. * * * the plaintiff, as the operator of the casinghead gas plant, is not entitled to a depletion because of the exhaustion of gas reserves which belong to another. * * * In these cases [*Palmer* v. *Bender*, 287 U. S. 551; *Reynolds* v. *Cooper*, 64 F. (2d) 644 (C. C. A. 10th), affirmed, 291 U. S. 192], the taxpayer had an interest in the minerals "in place"—as lessor, lessee, or the assignee of some interest in the lease, and the court was particular twice to limit its holding to oil "in place." One who buys the oil at the mouth of the oil well owns the oil, but has no interest in it "in place."
>
> * * * * *
>
> Counsel relies upon *Signal Gasoline Corp.* v. *Commissioner*, (C. C. A. 9), 66 F. (2d) 886, which may be distinguished on the facts, since in that case the taxpayer pumped gas after the wells ceased producing oil, a con-

> dition not here present. Here, the vacuum pressure which increased recovery was incidental to the transportation of the gas. The sole authority for this decision is *Palmer* v. *Bender, but the court overlooked entirely the qualifying words "in place" twice used in that opinion.* * * * [Italics supplied.]

This holding, we submit, is correct and applicable here. This respondent had no more interest in the wet gas reserves than an oil refinery has in the oil in place. The producers were the owners of the wet gas and, like the owners of oil produced, were entitled to depletion on one hundred per cent of the gross proceeds therefrom.

The court below has recognized that the mere possession by a casinghead gasoline manufacturer of a contract right to receive the entire product of a particular well does not constitute him the owner of the wet gas as produced. In *Signal Gasoline Corp.* v. *Commissioner,* 77 F. (2d) 728, the court rejected the contention of such a manufacturer that he was entitled to percentage depletion figured upon the gross proceeds of the gasoline and dry gas extracted from the wet gas, less the amount of the "royalties" paid to the producer. Such a claim, the court pointed out, was subject to a double vice. It included in the basis for depletion the value added to the wet gas by the manufacturing process, contrary to the holding of that and other circuit courts of appeals that "gross income from the property" means gross income from the sale of the natural

product at the well only. *Brea Cannon Oil Co.* v. *Commissioner*, 77 F. (2d) 67 (C. C. A. 9th); *Consumers Natural Gas Co.* v. *Commissioner*, 78 F. (2d) 161 (C. C. A. 2d), certiorari denied, 296 U. S. 634; *Greensboro Gas Co.* v. *Commissioner*, 79 F. (2d) 701 (C. C. A. 5th), certiorari denied, 296 U. S. 639. Compare *Helvering* v. *Twin Bell Oil Syndicate*, *supra*. But the contention also treated the manufacturer as the owner of the natural product, the wet gas—just as if he himself were the lessee-operator paying "royalties" to a lessor-owner. This the court said was erroneous if the royalties were equal to the market value of the wet gas. See pp. 11–12, *supra*.

It is manifest, we submit, that if the casinghead manufacturer is not the owner of the wet gas as produced in the case supposed, he does not become the owner *pro tanto* merely because of a contract right to receive the wet gas for less than its market value. The transaction remains one of purchase, though made at a bargain price. In the case of the processing contracts it remains one of agreement for sale of the manufactured product on behalf of the producer, though the commission be specially advantageous. The respondent profits from a favorable contractual position. But it does not receive income "from the property"—in the correct sense of income from the sale of the natural product at the well—to which it must look for a return of its capital. Its interest is wholly one arising out of an advantageous contract.

The holding that such an interest constitutes an economic interest in the mineral in place within the meaning of the decisions of this Court is irreconcilable with the concept of depletion as compensation for the wasting of a capital asset through production of taxable income. That this is so is conclusively shown by the fact that the supposed capital asset would cease the moment the contract ceased to be advantageous. Thus with a return of the prevailing market value to the price fixed by the contract the respondent's "capital investment" would be entirely wiped out. Susceptibility to loss of this character is a mark of a contract of purchase, not of ownership. Clearly it is improper to allow depletion for the wasting of an "investment" which is dependent for its very existence upon shifting price trends.[6]

[6] Wet gas, it is to be noted, is not sold at a price per unit at the mouth of the well, nor is its price stated in terms of dollars and cents. The manufacturer pays for the gas a proportion of the gasoline ultimately extracted (or its proceeds), the proportion presumably varying according to the cost of manufacture and the current price of gasoline as well as the supply of wet gas and, perhaps, the disposition of dry gas (R. 151). The respondent computes its "depletable interest" by deducting the number of gallons of the manufactured products actually paid under the contract (33⅓%) from the number which would have been paid at the going rate (allegedly 45% to 50%) and then determining the market value of the difference (R. 150–152). The court below did not finally determine the propriety of this method of fixing market value of wet gas. Nor did it determine by what method the taxpayer's "net income from the property" should be computed for the purposes of the statutory limitation upon the allowance.

The court below proceeded upon the assumption, implicit in the case at bar and virtually explicit in the *Signal Gasoline Corp.* case, *supra,* 77 F. (2d) at 730, that "gross income from the property" must necessarily equal the market value of the product. It seems evident that the assumption is erroneous. Congress has taken the gross income of the owner from the product as the basis of percentage depletion, not the product's market value. The owner of an oil or gas lease may sell his product under a long-term contract at less than its market value just as the owner of a manufacturing business may do. An economic advantage consisting merely of the contractual right to acquire the natural product at less than its market value no more constitutes ownership of the natural product in place than a similar right with respect to a manufactured product would constitute ownership of the factory.

It cannot in any sense be said in this case that respondent secured "by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital." See *Palmer* v. *Bender, supra,* p. 557. Since it is the mineral deposit which is depleted by production, the respondent whose interest is confined to the extracted mineral is not within the class of "mines, oil and gas wells, other natural deposits, and timber," to which the depletion section alone applies.

## CONCLUSION

In view of the foregoing we respectfully submit that the decision of the Circuit Court of Appeals should be reversed.

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JANUARY 1938.

## APPENDIX

Revenue Act of 1926, c. 27, 44 Stat. 9:

SEC. 204. * * *

(c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—

* * * * *

(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

SEC. 234. (a) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * *

(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the de-

ductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee; * * *

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * *

(*1*) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction shall be equitably apportioned between the lessor and lessee. * * * (For percentage depletion in case of oil and gas wells, see section 114 (b) (3).)

(*m*) *Basis for depreciation and depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(*a*) *Basis for depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in section 113 for the purpose of determining the gain or loss upon the sale or other disposition of such property.

(b) *Basis for depletion.*—

* * * * * *

(*3*) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the

allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

Treasury Regulations 69, promulgated under the Revenue Act of 1926:

ART. 201. *Depletion of mines, oil and gas wells; depreciation of improvements.*—Sections 214 (a) (9) and 234 (a) (8) provide that taxpayers shall be allowed as a deduction in computing net income in the case of natural deposits a reasonable allowance for depletion of mineral and for depreciation of improvements. See section 204 (c) and articles 1602 and 221 with reference to the basis for computing depreciation and depletion.

The essence of these provisions of the statute is that the owner of mineral deposits, whether freehold or leasehold, shall, within the limitations prescribed, secure through an aggregate of annual depletion and depreciation deductions the return of either the cost of his property, or the value of his property on the basic date plus, in either case, subsequent allowable capital additions (see articles 222 and 223), but not including land values for purposes other than the extraction of minerals. (But see section 204 (c) (2) and article 221.)

Operating owners, lessors, and lessees, whether corporations or individuals, are entitled to deduct an allowance for depletion and depreciation, but a shareholder in a min-

ing or oil or gas corporation is not allowed such deductions. (But see article 1546.)

ART. 1602. *Basis for allowance of depletion and depreciation.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence will be allowed in respect of any property is the same as is provided in section 204 (a) and (b) for the purpose of determining the gain or loss from the sale or other disposition of such property, except that:

* * * * *

(2) With respect to oil and gas wells, the allowance for depletion shall be 27½ per cent of the gross income from the property during the taxable year, but such allowance shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. In no case shall the deduction for depletion with respect to oil and gas wells be less than it would be if computed without reference to section 204 (c) (2) and this paragraph.

See articles 201–237 for the methods of computing allowances for depletion, and articles 161–170 with reference to the allowance for depreciation.

Treasury Regulations 74, promulgated under the Revenue Act of 1928:

The applicable Articles of these Regulations are substantially similar to the corresponding Articles in Regulations 69, *supra*, and are not copied here (Cf. Articles 221, 611, Treasury Regulations 74).

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